

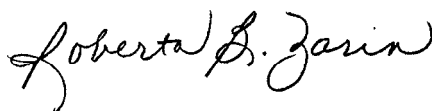
## PREFACE

Exempt Organizations (EO) is dedicated to fulfilling the IRS mission to help all customers understand and meet their tax responsibilities. Customer Education & Outreach (CE&O) works closely with Exempt Organizations staff to accomplish this by:

- Developing tailored education programs for customer sub-segments,
- Coordinating the development, revision and design of forms, publications and other non-speaker outreach activities,
- Making standardized educational materials available for outreach efforts, and
- Establishing a means for customers to be heard.

This workshop and our materials are part of a tailored program for representatives of small and mid-sized exempt organizations. We hope that this text helps you become more familiar with tax laws governing exempt organizations and understand how compliance with these laws will strengthen your organization.

The material in this book is for educational use only and may not be cited as precedent.



Roberta “Bobby” Zarin  
Director, Customer Education and  
Outreach, Exempt Organizations

# Exempt Organizations Workshop

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<b>Objective</b>	<p>Upon completion of this text you will know what an organization exempt under section 501(c) of the Internal Revenue Code must do to:</p> <ul style="list-style-type: none"><li>• Determine which of your income-producing activities generate UBI;</li><li>• Apply applicable exceptions, exclusions, and deductions when calculating your UBI tax;</li><li>• Report your organization's UBI appropriately; and</li></ul>
<b>Please Note</b>	<p>The material in this text is for educational use only in association with the Exempt Organizations Workshop. It is not intended to establish Internal Revenue Service positions and may <u>not</u> be relied upon or cited as precedent.</p>
<b>For More Information</b>	<p>This text primarily focuses on requirements for 501(c)(3) organizations. Some basic information is presented about organizations exempt under other code sections as well. For a more detailed discussion, including exceptions to the general information provided in this text, please refer to the publications and sections of law cited in the material. Each chapter of this text contains a complete list of references.</p>
<b>Legal Authority</b>	<p>The Internal Revenue Code appears as Title 26 of the United States Code. Congress originally enacted the Internal Revenue Code on August 16, 1954, as the Internal Revenue Code of 1954. It was comprehensively updated when Congress passed the Internal Revenue Act of 1986 on October 22, 1986. Both of these original laws have been amended numerous times by Congress. The resulting body of law guides all tax administration in the United States.</p> <p>The IRS issues regulations that set forth its interpretation of the law. The regulations are issued over the signature of the Secretary of the Treasury (or his delegate) under Title 26 of the Code of Federal Regulations. The regulations carry more weight than any rulings or releases on tax matters otherwise issued by IRS or the Treasury.</p>
<b>Internal Revenue Code (IRC) Citations</b>	<p>All references are to the Internal Revenue Code (IRC) unless otherwise stated. For example, “section 501(c)(3)” refers to Internal Revenue Code section 501(c)(3). The Internal Revenue Code is also sometimes referred to as simply “the Code”.</p>

## CHAPTER 4

### UNRELATED BUSINESS INCOME (UBI)

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#### **Unrelated Business Income Tax**

A section 501(c)(3) tax-exempt organization may engage in income-producing activities unrelated to its tax-exempt purposes as long as the unrelated activities are not a substantial part of the organization's activities overall. However, the net income from such activities will be subject to the Unrelated Business Income Tax (UBIT) if the following three conditions are met:

- The activity constitutes a trade or business,
  - The trade or business is regularly carried on, and
  - The trade or business is not substantially related to the exercise or performance of the organization's exempt purpose.
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#### **Trade or Business**

The term "trade or business" generally includes any activity carried on for the production of income from selling goods or performing services.

An activity does not lose its identity as a trade or business merely because it is carried on within a larger group of similar activities.

Example: The regular sale of pharmaceutical supplies to the public by a hospital pharmacy that also furnishes supplies to the hospital and its patients is a trade or business.

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## UNRELATED BUSINESS INCOME, Continued

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### **Regularly Carried On**

Business activities are considered regularly carried on if they show a frequency and continuity and are pursued in a manner similar to commercial activities of nonexempt organizations.

*Example:* A hospital auxiliary's operation of a sandwich stand for 2 weeks at a state fair would not be the regular conduct of a trade or business. However, operating the sandwich stand daily at the hospital would be the regular conduct of a trade or business.

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### **Not Substantially Related**

A business activity is not substantially related to an organization's exempt purpose if it does not contribute importantly to accomplishing that purpose (other than through the production of income or funds). The fact that the organization used the income to further its charitable purposes does not make the activity substantially related to its exempt purposes. Whether an activity contributes importantly depends upon on the facts of each case.

In determining if activities contribute importantly to accomplishing an exempt purpose, the size and extent of the activities involved must be considered in relation to the nature and extent of the exempt function they serve. If an activity is conducted on a larger scale than is reasonably necessary to perform an exempt purpose, it does not contribute importantly to accomplishing the organization's exempt purposes. An activity does not lose its identity as a trade or business merely because it is carried on within a larger group of similar activities that may be related to the organization's exempt purposes.

*Example:* The hospital sandwich stand that operates daily would generate both related and unrelated business income. Income from sales to hospital staff and patients would be related (because of the "convenience" exception, explained below), while income from sales to the general public would be unrelated. Only income from sales to the public would be subject to UBIT.

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## UNRELATED BUSINESS INCOME, Continued

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### **Examples of Unrelated Trade or Business Activities**

Examples of some of the more common forms of unrelated trade or business activities include:

- Advertising
  - Gaming
  - Sale of merchandise and publications
  - Rental income
  - Parking lots
  - Debt management plan services
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### **Advertising**

Many tax-exempt organizations sell advertising in their publications or other forms of public communication. Generally, the sale of advertising will generate unrelated trade or business income. This may include the sale of advertising space in bulletins, magazines, and journals, or on the organization's website.

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### **Gaming**

Most forms of gaming, if regularly carried on, may be considered the conduct of an unrelated trade or business. This can include Beano, raffles, lotteries, pull-tabs, scratch-offs, pari-mutuel betting, Calcutta wagering, pickle jars, punchboards, tip boards, tip jars, "instant" bingo, and certain video games.

(Bingo, defined and discussed below, does not generate UBI for 501(c)(3) organizations.)

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## UNRELATED BUSINESS INCOME, Continued

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### **Sale of Merchandise and Publications**

The sale of merchandise and publications as well as the actual publication of materials is considered to be an unrelated trade or business if the items involved do not have a substantial relationship to the exempt purposes of the organization.

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### **Rental Income**

Generally, income derived from the rental of real property and incidental personal property is excluded from unrelated business income. However, there are certain situations in which rental income may be unrelated business taxable income:

- If an organization rents out property on which there is a debt outstanding (for example, a mortgage note), the rental income may constitute unrelated debt-financed income subject to UBIT, or
  - If personal services are rendered in connection with the rental, then the income may be unrelated business taxable income.
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### **Parking Lots**

**Scenario 1:** An organization owns a parking lot that is used by organization members and visitors while attending organization activities. Any income from parking fees would not be subject to UBIT.

**Scenario 2:** An organization operates a parking lot that is used by members of the general public. Parking fees would be taxable, because providing parking to the general public is not substantially related to the organization's exempt purpose, and parking fees are not treated as rent from real property.

**Scenario 3:** An organization enters into a lease with a third party who operates the organization's parking lot and pays rent to the organization. If the organization did not have a mortgage on the parking lot, such payments would not be subject to tax as they would constitute rent from real property.

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### **Debt Management Plan Services**

Providing debt management plan services is considered unrelated trade or business when conducted by any organization other than a credit counseling organization that meets the requirements of section 501(q). Debt management plan services are services related to the repayment, consolidation, or restructuring of a consumer's debt. They include marketing and processing debt management plans and negotiating with creditors to lower interest rates or to waive or reduce fees.

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## UNRELATED BUSINESS INCOME, Continued

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### **Are there Exceptions to Unrelated Trade or Business Activities?**

The term "unrelated trade or business" is subject to several exceptions under which certain business activities that may otherwise constitute unrelated business are removed from the scope of the unrelated business income tax.

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### **Exceptions to UBI**

The main exceptions to the definition of unrelated trade or business are:

- Activities conducted substantially by volunteers
- Activities conducted for the convenience of members, students, patients, officers, or employees
- Sales of donated merchandise
- Distribution of "low-cost" articles that is incidental to the solicitation of charitable contributions
- Convention and trade show activity
- Qualified sponsorship income
- Bingo income

Other exceptions also apply, but they are less common and will not be covered in this text.

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## UNRELATED BUSINESS INCOME, Continued

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### **Activities Conducted by Volunteers**

The term "unrelated trade or business" does not include a trade or business in which substantially all the work in carrying on the trade or business is performed for an organization by a worker who does not receive compensation; i.e., a volunteer.

Example: A gift shop operated by an exempt orphanage in which all of the clerks are volunteers would not be considered an unrelated trade or business even though the operation of the store does not contribute importantly to any exempt purpose or function of the orphanage.

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### **Convenience**

The term "unrelated trade or business" does not include a trade or business which is carried on by either a 501(c)(3) organization or a state college or university primarily for the convenience of its members, students, patients, officers, or employees.

Example: A cafeteria operated by an exempt 501(c)(3) hospital to provide food for hospital staff, visitors, and patients would not be considered an unrelated trade or business.

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### **Sale of Donated Merchandise**

The term "unrelated trade or business" does not include the trade or business of selling merchandise if substantially all of the merchandise has been received as gifts or contributions.

Example: A thrift store operated by an exempt organization that sells clothes and other goods donated by members of the general public would not be considered an unrelated trade or business.

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### **Distribution of Low-Cost Articles**

The term "unrelated trade or business" does not include activities conducted by 501(c)(3) organizations and veterans' organizations that involve the distribution of low-cost items in conjunction with the solicitation of charitable contributions. Under the 2009 rate, an item is considered low cost if it is not valued at more than \$9.50. This threshold is adjusted annually for inflation.

Example: Contributions received by an exempt organization that distributes mailing labels with its solicitations for contributions would meet this exception because the mailing labels typically would cost less than the threshold amount.

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## UNRELATED BUSINESS INCOME, Continued

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### **Convention or Trade Show**

The term “unrelated trade or business” does not include activities conducted by a section 501(c)(3), (4), (5), or (6) organization at a convention, annual meeting, or trade show if one of the purposes of sponsoring the activity is to promote the products or services of an industry or educate attendees of new industry developments, products, and services, and the organization regularly conducts such trade shows as one of its exempt purposes.

*Example:* Renting display space to exhibitors at an annual meeting of a 501(c)(3) organization would meet this exception.

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### **Sponsorship Payments**

Payments to an exempt organization by a person engaged in a trade or business are not considered income from an unrelated trade or business if there is no arrangement or expectation that the payor will receive any return benefit other than the use or acknowledgement of the payor’s name or logo in connection with the exempt organization’s activities, or goods or services of insubstantial value.

“Use or acknowledgment” does not include advertising, but may include exclusive sponsorship arrangements, logos and slogans, a list of the payor’s locations, contact numbers, or Internet address, and value-neutral descriptions, displays, or depictions of the payor’s products or services.

*Example:* An exempt organization organizes an amateur sports team. A major pizza chain supplies the team uniforms and pays the team’s operational expenses. The uniforms bear the name and logo of the pizza chain. The use of the name and logo of the pizza chain constitutes acknowledgment of the sponsorship. Consequently, the funding and supplied uniforms are not considered income from an unrelated trade or business.

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## UNRELATED BUSINESS INCOME, Continued

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### **Bingo**

Income from the conduct of bingo games is not subject to unrelated business income tax if the bingo game is:

- The traditional type of bingo,
- Legal under state and local law, and
- Not ordinarily carried out on a commercial basis.

Traditional: A bingo game is a game of chance played with cards that are generally printed with five rows of five squares each. Participants place markers over randomly called numbers on the cards in an attempt to form a preselected pattern such as a horizontal, vertical, or diagonal line, or all four corners. The first participant to form the reselected pattern wins the game. Wagers must be placed, winners must be determined, and prizes must be distributed in the presence of all persons placing wagers in that game.

Satellite and Internet bingo do not qualify because these games are conducted in many different places simultaneously and the participants are not all present when the wagers are placed, the winners determined, and the prizes distributed. Instant bingo, Mini bingo, and similar scratch off cards are pull-tab games, not bingo.

Legal under state and local law: The exception only applies if the conduct of the bingo game does not violate any state or local law. If bingo is expressly prohibited under state or local law, it is immaterial whether state or local officials enforce the law.

Not ordinarily carried out on a commercial basis: The bingo exception also does not apply to bingo games conducted in a jurisdiction in which the games are ordinarily carried out on a commercial basis. Therefore, if for-profit businesses regularly conduct bingo games in any part of the jurisdiction, the bingo exception does not apply. Ordinarily, the jurisdiction is the entire state.

If, however, state law permits local jurisdictions to determine whether for-profit businesses may conduct bingo, or if state law limits or confines the conduct of bingo games by for-profit entities to specific local jurisdictions, then the local jurisdiction is the appropriate jurisdiction for determining whether bingo games are ordinarily carried out in a commercial manner.

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## UNRELATED BUSINESS INCOME, Continued

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<b>Expenses</b>	Expenses allocable to any activity that meets one of these exceptions may not be deducted when calculating the organization's UBIT.
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<b>Exclusions and Deductions from UBI</b>	In addition to the exceptions discussed earlier, the Code provides certain other exclusions and deductions from the calculation of the unrelated business income tax, including the following:
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### Exclusions

- Interest and dividends
- Royalties
- Rents
- Gains and losses from the sale of property

### Deductions

- Trade or business expenses deduction
  - Interest expense deduction
  - Deduction for losses
  - Net operating loss deduction
  - Charitable contribution deduction
  - \$1,000 specific deduction
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## UNRELATED BUSINESS INCOME, Continued

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### **Exclusions – Passive Income**

Most passive income is excluded from the scope of the Unrelated Business Income Tax.

**Interest and Dividends:** Interest, dividends, and certain other income from an exempt organization's routine investments are excluded when calculating the organization's unrelated business taxable income.

Example: Interest from the exempt organization's bank account is excludable.

**Royalty Income:** Royalties and all deductions directly connected with royalty income are excluded from the organization's unrelated business taxable income. Royalties are payments for the use of a right, such as a trademark, trade name, or copyright. However, when substantial services are required as part of the agreement to use a right, the payment is not a royalty but a payment for services.

Example: A payment from a manufacturer to an exempt labor organization for the use of the organization's logo in the manufacturer's advertising is considered to be royalty income.

**Rents from Real Property:** Rents from real property are excluded from the organization's unrelated business taxable income, as are rents from personal property leased with real property provided they are incidental to the total rent. This exclusion does not apply to rents from personal property that is leased without real property, rents from real property based on net profit, rents from real property when personal services are provided, or rents from real property that is debt-financed.

Rent received for the use of an exempt organization's hall for a wedding, where no services such as bartending or catering are provided and the building's mortgage has been paid in full, is an example of excluded rental income.

**Certain Gains and Losses from Sale of Property:** Gains and losses from the sale of property, other than inventory and property held primarily for sale in the course of a trade or business, are excluded in calculating unrelated business taxable income.

Example: Gain on the sale of stock held as an investment by an exempt organization is excluded.

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## UNRELATED BUSINESS INCOME (UBI), Continued

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### **Deductions**

In computing its unrelated business taxable income, an organization may subtract permissible deductions that are directly connected with the carrying on of the unrelated trade or business.

Before an expense can be deducted:

- The deduction must be allowed by Chapter 1 of the Code, which contains the general income tax provisions applicable to taxable organizations, and
- The deduction must be directly connected with the carrying on of the unrelated trade or business.

Unrelated business taxable income is calculated by aggregating the income and deductions attributable to all unrelated trades or businesses of the organization. Thus, a loss from one unrelated business can be used to offset income from another unrelated business.

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### **Dual Use of Assets or Personnel**

If assets or personnel of an organization are employed both in an unrelated trade or business and in exempt activities, then items of deduction attributable to such assets or personnel are allocated between the two uses on a reasonable basis. The portion of an item of deduction attributable to the unrelated business use is deductible in computing unrelated business taxable income.

*Example:* An organization owns a parking lot that is used by organization members and visitors during the day, but is rented out to patrons of a movie theater in the evening. Any income from parking fees collected during the day would not be subject to UBIT. However, parking fees collected from the evening movie-goers would be taxable, because providing parking to the general public is not substantially related to the organization's exempt purpose.

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## UNRELATED BUSINESS INCOME, Continued

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**Expense  
Allocation  
Methods:  
Example 1**

A school recognized as a tax-exempt organization contracts with an individual to conduct a summer tennis camp, an activity unrelated to the school's exempt purpose. The school provides the tennis courts, housing, and dining facilities. The contracted individual hires the instructors, recruits campers, and provides supervision. The income the school receives from this activity is from a dual use of the facilities and personnel. The school, in computing its unrelated business taxable income, may deduct an allocable part of the expenses attributable to the facilities and personnel. The school determined that the summer revenues were 40 percent student and 60 percent non-student (i.e., camper). School expenses (e.g., real estate taxes, building insurance, and personnel) totaled \$20,000.

Since only half of the school's facilities were used for an unrelated trade or business activity (tennis courts, housing, dining facilities, and personnel), 50 percent of these expenses can be allocated to this activity ( $\$20,000 \times .5 = \$10,000$ ). However, since the student use is not subject to tax, expenses attributable to them are not deductible. Therefore, only 60 percent of the \$10,000 expense allocated to the activity is deductible on Form 990-T ( $\$10,000 \times .60 = \$6,000$ ).

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**Expense  
Allocation  
Methods:  
Example 2**

XYZ Charity has an employee who spends 70 percent of his time on gaming activities and 30 percent on activities related to the charity's exempt purpose. The organization may allocate 70 percent of the employee's wages to unrelated business taxable income on Form 990-T.

**NOTE:** The organization should maintain adequate records and contemporaneous documentation to support how the employee's time was spent.

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## UNRELATED BUSINESS INCOME, Continued

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### Other Deductions

**Net Operating Loss:** A net operating loss deduction is allowed in computing unrelated business taxable income. This deduction is allowed in one tax year based on a loss generated in either a previous or subsequent tax year.

Example: During the first year of operation, an exempt organization had a net operating loss of \$10,000 from an unrelated trade or business activity. During its second year, net income from its unrelated trade or business activity was \$12,000. The organization may claim a net operating loss deduction of \$10,000 in the second year, based on the prior year loss, and reduce the unrelated trade or business income for the second year from \$12,000 to \$2,000.

**Charitable Contributions:** An exempt organization is allowed a deduction for charitable contributions. This deduction is limited to 10 percent of its unrelated business taxable income computed without regard to the deduction for contributions. To be deductible, the contribution must be paid to another qualified organization.

Example: An exempt university that operates an unrelated trade or business producing taxable income of \$100,000 may deduct up to \$10,000 of a charitable contribution to another university for educational work.

**“Specific” Deduction:** A specific deduction of \$1,000 is allowed in computing unrelated business taxable income. Only one specific deduction is allowed for each tax year, regardless of the number of unrelated businesses carried on by the organization.

Example: An organization with taxable income from an unrelated trade or business of \$15,000 pays tax on \$14,000.

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### Substantial UBI May Jeopardize Exemption

Generally, a section 501(c)(3) organization may have some unrelated trade or business income without any adverse impact on its exempt status. If, however, a 501(c)(3) organization’s unrelated trade or business activity is no longer insubstantial, the organization jeopardizes its exempt status.

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### Form 990-T: Who Must File

An exempt organization must file Form 990-T, *Exempt Organization Business Income Tax Return*, for any taxable year in which it has gross income from unrelated trade or business of \$1,000 or more. The requirement to file Form 990-T is in addition to the requirement to file Form 990, 990-EZ, 990-N, or 990-PF.

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## UNRELATED BUSINESS INCOME, Continued

<b>When to File</b>	Form 990-T is due the 15th day of the 5th month following the end of the organization's accounting period (tax year). For example, May 15 for a December 31st year-end.
<b>Extension of Time to File</b>	Corporations may request an automatic 6-month extension of time to file Form 990-T by using Form 8868, <i>Application for Extension of Time To File Exempt Organization Return</i> .
<b>Interest and Penalties</b>	An exempt organization may be subject to interest and penalty charges if it files a late return or fails to pay tax when due. Generally, the organization is not required to include the interest and penalty charges on Form 990-T because the IRS will calculate the amount and bill the organization for it.
<b>Form 990-W</b>	Generally, an organization filing Form 990-T must make installment payments of estimated tax if the total expected tax for the year is \$500 or more. Both corporations and trusts use Form 990-W, <i>Estimated Tax on Unrelated Business Taxable Income for Tax-Exempt Organizations</i> .
<b>For More Information</b>	<p>Publication 598, <i>Tax on Unrelated Business Income of Exempt Organizations</i></p> <p>Form 990-T, <i>Exempt Organization Business Income Tax Return</i>, and Instructions</p> <p>Form 990-W, <i>Estimated Tax on Unrelated Business Taxable Income for Tax-Exempt Organizations</i></p> <p>Form 1120, <i>U.S. Corporation Income Tax Return</i></p> <p>Form 8868, <i>Application for Extension of Time To File Exempt Organization Return</i></p>
<b>Forms and Publications</b>	You may order Forms and Publications by calling (800) 829-3676 or by downloading them from <a href="http://www.irs.gov/">www.irs.gov/</a> .



## CLOSING

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### **Exempt Organizations and the Internal Revenue Service**

The goal of the Exempt Organizations office of the IRS is to promote compliance with the tax laws governing exempt organizations. It does this:

- Through outreach and educational efforts
  - By issuing rulings that apply tax laws to an exempt organization's specific set of facts
  - Through examinations and other compliance activities
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### **Ways Exempt Organizations Can Get Help from the IRS**

The IRS has several ways that officers or representatives of exempt organizations can get help on tax issues:

Customer Account Services: Call (877) 829-5500 (toll free). Ask Exempt Organizations specialists general questions about exempt organizations or questions about a specific organization's account. The caller must have the organization's employer identification number (EIN) handy and know the organization's legal name.

For some account-specific questions, the caller will need to establish his or her right to access the information. He or she must be an authorized officer or a representative of the organization with power-of-attorney rights.

EO Website: Point your browser to [www.irs.gov/eo](http://www.irs.gov/eo) for a wealth of information and "how-to" assistance including:

- Descriptions, rules, and requirements for different types of exempt organizations
  - Life Cycle of an Exempt Organization
  - Published guidance
  - Tips on how to avoid filing errors
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## CLOSING, Continued

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### **More Ways Exempt Organizations Can Get Help from the IRS**

Web-based Training. Go to [www.stayexempt.irs.gov](http://www.stayexempt.irs.gov) to participate in a “virtual” workshop or to view on-line “mini-courses” on a variety of EO topics.

Forms and Publications: Call (800) 829-3676 to order free IRS publications and forms or download them from the IRS website at [www.irs.gov/](http://www.irs.gov/).

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### **For More Information**

General IRS Questions: (800) 829-1040 (toll-free)

TEGE Customer Service: (877) 829-5500 (toll-free)  
(EO questions)

Forms and Publications: (800) 829-3676 (toll-free)

IRS Internet Site: [www.irs.gov](http://www.irs.gov)

EO Page: [www.irs.gov/eo](http://www.irs.gov/eo)

On-line Training: [www.stayexempt.irs.org](http://www.stayexempt.irs.org)

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### **The IRS Needs YOUR Help**

The IRS would like your feedback on our products. Please contact us with your recommendations on changes or additions that would improve your understanding of exempt status requirements.